How Emerging Markets Can Help Unwind the Global Imbalances

Speech by Mr. Thirachai Phuvanatnaranubala

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In the past, trade imbalances will unwind itself over time. But today's imbalances have been going on for many years. Why have they not unwound?

Normally an emerging market that first enters globalization through manufacturing will quickly build up trade surpluses. Its labor costs, starting from a low base, will make its exports especially competitive. Capital investments will quickly increase labor productivity. However, after some time, its currency and its wages will rise, leading to more imports and help unwind the imbalances. But why has this not yet occurred?

There are three reasons. (1) In many emerging markets, wages are still low, especially in China. (2) Compared to agricultural and services, manufacturing exports tend to give higher share of profit to the companies more than the workers. (3) In China, the role of state enterprises is very prominent. Assets of state enterprises are as high as 130% of GDP, compared to 28% in France. The model of active state commercial role does not promote the opportunity for small businesses and entrepreneurs, which is the usual way to spread income and wealth more widely.

As a result, the ratio of private consumption to GDP in China is currently only about 35%, compared to 50-60% in other BRIC countries and Korea at the same level of development. There are calls for the Chinese households to save less and spend more. But since savings are done more by companies, through their retained earnings, than by households, this suggestion will not have immediate effect.

What can the advance markets like the US do to cut down its trade deficits?

The US simply has to consume less, or produce and sell more. There are two channels for the US to adjust, the external and the internal. The external channel is to have a weaker US dollar against all emerging market currencies. It will lower American buying power, and will be less painful. The internal channel is to lower American real wages. The economy will have to slow down, increasing unemployment. Labor flexibility was a key ingredient for recovery in Japan, and the same will have to happen in the US.

What about the emerging markets? What can they do?

Right now, all the attention is on QE2. Countries are busy debating whether or not to employ capital control, and in what form. Capital control can help individual emerging markets to delay the currency adjustment process, nevertheless cannot be the answer for all. But there are other things that emerging markets can do.

First, emerging markets can allow their currencies to strengthen. But this must start with China. No other country can really allow its currency to diverge too far from the Yuan because many are part of the same supply chain.

Second, emerging markets should be more aggressive in raising minimum wages, or allow more collective wage bargaining. It can also push companies to provide more welfare for their workers, especially in healthcare, retirement benefits and redundancy payment. This will help reduce the need for households to save.

Finally, emerging markets should open up their financial system. Today, the big Chinese banks concentrate its lending mainly to state enterprises. There should be more banks that earmark entrepreneurs and small and medium size businesses, as well as consumer finances. The banking system should help to transfer individual’s future income streams to finance today’s purchases of cars, houses and children’s education. This is the best way to help to increase domestic consumption.

Emerging markets have to make a choice. They can either help in the global adjustment process or they can force all the adjustments onto the advanced markets.

The more that the weight of the adjustments falls on the advanced markets, the more painful it will be for their citizens. Unemployment will remain high for a long time. Frustration will build up. And it can even lead to wars – both the currency kind and the trade kind.